

Office of Chief Counsel
Internal Revenue Service
Memorandum

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U.I.L. 3401.04-02
date: March 31, 2009

to:

Gulf Coast Group

from: Area Counsel (Gulf Coast Area)
(Tax Exempt & Government Entities)

subject:	Worker Classification of	Review Board Members
	Taxpayer:	District
	EIN:	

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Issues

1. Are Review Board () Members considered public officials for purposes of section 3401(c)¹?
2. Are Members employees or independent contractors?
 - a. Are the members covered by a section 218 agreement?
 - b. Are the members employees under the common law test?
 - c. Does law control whether Members are employees under the common law test for federal employment tax purposes?.
3. If Members are employees, who is the employer?
4. If Members are employees, does qualify for section 530 relief?

Conclusions

1. Yes, Members appear to meet the definition of public official under section 3401(c), and therefore should be treated as employees for federal income tax withholding purposes.
2. members appear to be employees.
 - a. If members are determined to be covered under a section 218 agreement, they should be treated as employees for the purposes of applicable FICA taxes, although the Social Security Administration has jurisdiction over the resolution of this issue.
 - b. If members are not covered under a section 218 agreement, they most likely still qualify as employees under the common law test for purposes of applicable FICA taxes, although liability for social security tax is dependent on whether or not the workers are covered by the state retirement system.
 - c. No, state statutes and other state law authorities are not controlling for purposes of determining whether a worker is an employee or independent contractor for purposes of federal employment taxes, although they may be relevant to the extent that they illuminate whether a right of control exists on the part of the State or the circumstances of the working relationship for purposes of applying the common law test.
3. Even if is not the common law employer, appears to be the 3401(d)(1), or statutory, employer for income tax withholding and employment tax purposes, because has control over the payment of wages to the members.

¹ All statutory references are to the Internal Revenue Code unless otherwise stated.

4. Further factual development from the taxpayer is required before we are able to determine whether section 530 relief may be applicable with regards to the members. If a section 218 agreement applies to the Members, then section 530 relief is not available with respect to Medicare taxes owed, however section 530 relief may be available with regards to retroactive, but not prospective federal income tax withholding obligations and social security taxes. If no section 218 agreement is applicable, then section 530 relief may be available to the taxpayer.

FACTS

The () is a State agency which is run by an appointed Board of Directors. The has statutory authority to establish minimum standards for the administration and operation of districts such as . Some rules have been published in the Administrative Code, primarily related to the form and procedure for to seek review of , to provide standards for the records required to be kept by the

districts, and guidance for arbitration of decisions.²

The system follows a system of checks and balances. An District Board of Directors hires the , sets the budget, and appoints the approximately Review Board () members. The Directors have no authority to or methods. The carries out the district's legal duties, hires the staff, makes , and operates the office.

The is established by Code (the Code), According to the Review Board Manual, which is published by :

The is the judicial part of the system. The is a separate body from the office and serves a different function. It hears and resolves protests over matters. This is a very broad and important responsibility, but the must be sensitive to its legal and practical limits.

The only has authority over protests that are submitted to them after first being informally reviewed by the . members must take an official oath.

You have detailed many of these policies and procedures in the materials you provided to us, which we incorporate by reference and summarize generally here. The Review Board Manual, published by the state, provides detailed procedures and standards for conducting hearings and meetings. A committee of the establishes local policies and procedures which are set out in the

² Admin Code .

Review Board Policies and Procedures Manual, and which all members must adhere to.³ In a county, such as , the members hear cases in panels and then submit their recommendations to the generally for approval. A panel chair person leads each hearing and receives internal training from the on specifically what needs to be covered at each hearing. These decisions are then entered by the and appealable in the state district courts. The members are compensated on a per diem basis, sign in and out of hearings, and generally work on a seasonal basis. Training is required by the State for all new members. members cannot work for more than one . members are limited by statute to terms,

The exists by statute. Code section establishes for each district and sets out eligibility requirements, term limits, and removal procedures and grounds, which include dereliction of duty and violation of conflict of interest prohibitions. The Manual provides more specific procedures for disciplining and removing appointed members. Code section sets out restrictions on member eligibility. Generally, an individual is ineligible for membership if they are related within a certain degree to , have exceeded term limits, or:

...is a member of the board of directors, an officer, or employee of the district, an employee of the , or a member of the governing body, officer, or employee of a .

In , former members of the board of directors, officers, or employees of the district are also ineligible. Other provisions address other conflict of interest situations, such as interests in contracts and ex parte communications with regarding cases before the . Code sets basic requirements for the organizational structure and meetings of the and specifies that compensation to members is a per diem set by the district budget for each day and reimbursement for actual and necessary expenses.

The is required to maintain independence from the district for purposes of the review hearings it conducts and is self-governed within the guidelines established by statute and the . However, the budget is part of the district budget. members serve on three member panels and are paid a set amount for each day or half day that they serve. The members are issued Forms 1099 using the TIN, the payments are recorded in the accounts payable, and the payments are issued from the bank account. All supplies and equipment, clerical staff, and legal services needed by the members are paid for from the budget.

³ For purposes of this analysis we assume that the follows the procedures set out in both the state and local level manuals.

argues that members cannot be employees of the district because of the above quoted language in Code § . The provided an opinion that the language is a “conflict of interest” concern rather than a prohibition. You indicated that views an employee as someone working on a permanent, full-time basis. A , 20 letter from ’s General Counsel first contended that the has no authority to interpret the Code with regard to the operation and management of districts and review boards.

The letter also argued the members themselves controlled the material details of how they perform their duties. A large portion of the argument focuses on the statutorily required independence of the , as it carries out its quasi-judicial functions, from other functions of the district, such as prohibitions on ex parte communications. also provided a brief letter from an outside attorney stating support for the General Counsel’s opinions and emphasizing the language of Code § by arguing, “It would be improper for the Service to take a position that is contrary to such a clear expression of legislative intent.”

State law does not prevent the from being established as a separate entity with its own TIN and bank account. The manager stated that the State was considering requiring the to “show” independence from the district by obtaining a separate TIN and bank account and admitted that members would probably be treated as employees of such a newly created separate entity.

You provided a copy of a Medicare-only 218 Agreement entered into for between the Secretary of Health and Human Services and the State of which is effective on , . The agreement states that none of the optional positions and services would be excluded. also entered into an agreement, effective on , , that eligible employees would be covered by the state retirement system.

LAW AND DISCUSSION

1. Public Official Status for Income Tax Withholding Purposes

I.R.C. § 3401(c) provides that, for income tax withholding purposes, the term “employee” includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing. Thus, by federal statute, public officers are specifically included within the term “employee” for income tax withholding purposes (and conversely are *not* “independent contractors” for income tax withholding purposes). Section 31.3401(c)-1(a) of the Employment Tax Regulations clarifies the officers or employees can either be elected or appointed.

Whether a state worker is a public officer under section 3401(c) is determined by reference to local law. The Code does not define the term “public officer,” but section 1.1402(c)-2(b) of the Income Tax Regulations gives the following examples of persons performing services of a “public office”: the president, the vice president, a governor, a mayor, the secretary of state, a member of Congress, a state representative, a county commissioner, a judge, a justice of the peace, a county or city attorney, a marshal, a sheriff, a constable, a registrar of deeds, or a notary public.⁴

There is, however, a body of case law defining the term “public official.” In *Buckley v. Valeo*, 424 U.S. 1 (1975), the Supreme Court stated that anyone who exercises significant authority pursuant to the laws of the United States is an officer.⁵ The term “officers” embraces all appointed officials exercising responsibility under the public laws of the nation. *Id.* 424 U.S. at 131. Officers perform a significant governmental duty exercised pursuant to a public law, and administer and enforce the public law. *Id.* 424 U.S. at 139, 141.

More specifically addressing the definition of officer is *Metcalf & Eddy v. Mitchel*, 269 U.S. 514 (1926), where the Supreme Court considered whether consulting engineers hired by states, municipalities, or water supply and sewage districts were independent contractors or “officers and employees” of a state. The court explained that an office is a public station conferred by the appointment of a government. The term “officer” embraces the idea of tenure, duration, emolument and duties fixed by law, and where an office is created, the law usually fixes its incidents, including its term, its duties and its compensation.” *Id.* 269 U.S. at 520 (citations omitted). Conversely, the independent contractor has liberty of action which excludes control or the right to control characteristic of the employer-employee relationship. *Id.* 269 U.S. at 521.

In *Pope v. Commissioner*, 138 F.2d 1006 (6th Cir. 1943), the Sixth Circuit, following *Metcalf & Eddy*, established the following standards to define the term “public office:” (1) It must be created by the constitution, the legislature, or by a municipality or other body with authority conferred by the legislature; (2) There must be a delegation of a portion of the sovereign powers of government to be exercised for the benefit of the public; (3) The powers conferred and the duties to be discharged must be defined either directly or indirectly by the legislature or through legislative authority; (4) The duties must be performed independently and without control of a superior power other than the law; and (5) the office must have some permanency and continuity, and the officer must take an official oath.

In summary, a public official is an agent of the state with the power to act on behalf of the state. The duties of the office, and frequently its compensation, are defined by statute. An official acts with a certain amount of independence under the law, but many

⁴ Section 1402(c)(1) of the Code provides in relevant part that the term “trade or business” for self-employment tax purposes shall not include the performance of the functions of a public office.

⁵ This case arose in the context of an issue concerning federal elections, not federal taxes. Similarly, the two cases, *Metcalf* and *Pope*, cited to in the two paragraphs that follow *Buckley* are not federal tax cases.

officials are also responsible to other officials, as specified in statutes or ordinances. A public official does not have the freedom from supervision characteristic of an independent contractor.⁶

Rev. Rul. 61-113, 1961-1 C.B. 400, dealt with individuals who served as members of a hearing board of an air pollution control district, who were appointed by the county board of supervisors, took an oath of office, held public hearings, and submitted their decisions to the county. They were not under the control and direction of the county board of supervisors or any other body. Their compensation was based on the number of hearings they attended. The Ruling held that the board members services constituted the performance of the functions of a public office and therefore did not constitute a "trade or business" for purposes of self-employment taxes under Code section 1402(c)(1).

Boards and commissions are created by state statute. Consultation of these statutes is likely to show that these positions are defined as public officers of the states or their political subdivisions or instrumentalities.⁷ In the case of the _____ members, the statute establishing the position, as well as the detailed training and manual provided by the State _____, appear to provide ample evidence that _____ members are public officials, and therefore employees for purposes of income tax withholding. For instance, the _____ is created by state legislation and it functions in a quasi-judicial capacity. An _____ member is entitled to judicial immunity for their actions concerning formal protest hearings. _____. The broad contours of the _____ powers and responsibilities are defined by statute and more specifically described by the _____ office, which may use its delegated authority to establish minimum standards and procedures for the office. _____ members perform their hearing and decision duties in accordance with the state code and the procedures established by the _____ and by the _____ itself, but without direct control by the Board of Directors. The state statute also establishes a formal process for removing _____ members.

The _____ bears many similarities to the hearing board of the air pollution control district considered in Rev. Rul. 61-113. Members are appointed by a board of supervisors, must take an official oath, and hold public hearings and submit their decisions to a _____ official; however, they are not under the direction or control of that board. The _____ members are also compensated on a per diem basis in accordance with statutes.

These statutory provisions and cases strongly support the view that in _____ an member is a public officer whose compensation is subject to income tax withholding

⁶ We note that it is possible that some appointed officials may be given sufficient independence that they would not be employees under the common law.

⁷ The _____ Attorney General has opined that _____ members are "local public officials" for purposes of special conflict of interest provisions found in C _____ Code. _____ . Section _____ of the _____ Code defines "local public official" as "a member of the governing body or another officer, whether elected, appointed, paid, or unpaid, of any district ... who exercises responsibilities beyond those that are advisory in nature."

under section 3401(c).

2. Employee Status for FICA Purposes

A. 218 Agreement

The question of whether the members are covered by 's Medicare-Only 218 Agreement is relevant to your inquiry. Therefore, it must be determined whether an individual worker is covered under a section 218 agreement.⁸ The specific provisions of the agreements were negotiated by SSA and the State, and the State Social Security Administrator traditionally has had jurisdiction over determining the scope and application of the agreements. The terms used in the agreements are defined in the Social Security Act and that statute contains the relevant statutory authority. Prior interpretations of the agreements have been made by the State Social Security Administrator and the State Administrator should have familiarity with (or have background files indicating) the intent of the agreements, and the amendments to the agreements. For these reasons, we believe the State Social Security Administrator has jurisdiction over interpretations of section 218 agreements.

Thus, in audits where interpretations of section 218 agreements are at issue, the Service should contact the State Social Security Administrator to determine the State's and SSA's interpretation of whether an individual is covered under the agreement. The Social Security Administrator determines whether the workers are employees within the meaning of section 210(j) of the Social Security Act, which applies the common law rules. If the State Social Security Administrator determines that an individual worker is covered under the section 218 agreement, the Service then has jurisdiction over the determination of the wages for FICA tax purposes and the liability for FICA taxes with respect to remuneration paid to such individual. See I.R.C. section 3121(d)(4). If the State Social Security Administrator determines that an individual worker is not covered under the section 218 agreement, the Service then determines whether the worker is an employee under the common law rules. See I.R.C. section 3121(d)(2). If the worker is an employee under the common law rules, but not covered under the section 218 agreement, then a determination needs to be made whether the individual is a "member of a retirement system." See section 3121(b)(7)(F) and section 31.3121(b)(7)-2 of the Employment Tax Regulations. If the employee is not covered under the section 218 agreement and is not a member of a retirement system, then remuneration for the services of the employee is generally subject to the social security tax (i.e., the taxes imposed by sections 3101(a) and section 3111(a)) and the Medicare tax (i.e., the taxes imposed by section 3101(b) and section 3111(b)).

Although it is our view that the determination of who is covered under the terms of a section 218 agreement is under the jurisdiction of the State Social Security Administrator and the Social Security Administration, the final determination of federal

⁸ Section 218 refers to the Social Security Act, codified at 42 U.S.C. § 418. See I.R.C. sections 3121(b)(7)(E) and 3121(d)(4) for treatment of individuals performing services covered by a section 218 agreement as employees for FICA tax purposes.

tax liability is under the jurisdiction of the Service. The enforcement mechanism with respect to section 218 agreements is also with the Service because the payments under the agreements are treated as FICA taxes.

While the Social Security Administration is the final arbiter of coverage issues related to section 218 agreements, we note that the section 218 agreement contains no exclusions for employees hired after . We point out that only the Medicare portion of FICA taxes would be applied in the present case under the section 218 agreement because the applicable section 218 agreement is limited to Medicare-only. Determining whether the social security tax portion is owed depends on whether the workers are members of the state retirement system. See section 3121(b)(7)(F). We note that eligible employees of are covered by the state retirement system, but it is likely that seasonal employees, such as panelists, might not be eligible for coverage under the state retirement system.⁹

B. Is the Common Law Test Applicable?

If the members are covered by the Medicare-only section 218 agreement, there is a question concerning whether an individual covered under a Medicare-only 218 agreement is an employee for purposes of social security tax. Section 3121(d)(4) provides that "for purposes of this chapter, the term "employee" means any individual who performs services that are included under an agreement entered into pursuant to section 218 of the Social Security Act. The chapter referred to is chapter 21- Federal Insurance Contributions Tax Act which imposes social security tax and Medicare tax on employers and employees. Section 3121(d)(4) also does not provide that the term "employee" excludes an individual who performs services that are included under a Medicare-only 218 agreement .

Thus, if the members are covered under the Section 218 agreement, they are "employees" for purposes of the social security tax under section 3121(d)(4) because for purposes of Chapter 21 they perform services that are included under an agreement entered into pursuant to section 218 of the Social Security Act. Consequently, you do not need to make an independent determination under the common law rules under section 3121(d)(2) for determining the status of an individual as an employee for social security tax purposes. However, if it is determined that the members are not covered by the Medicare-only 218 agreement, then the common law rules described in the following paragraphs apply.

Section 31.3121(d)-1 of the Employment Tax Regulations describe the common law rules applicable in determining whether a worker is an employee. See also Treas. Reg. § 31.3121(d)-1(c)(1). Such a relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and

⁹ We do not opine in this memorandum on the issue of whether or not the members are covered by the state retirement system.

means by which that result is accomplished. It is not necessary that the employer actually direct or control the manner in which the services are performed; It is sufficient if he has the right to do so. Treas. Reg. § 31.3121(d)-1(c)(2). This determination is based on the facts and circumstances.

In determining whether an individual is an employee or an independent contractor under the common law, all evidence of control, and lack of control or autonomy must be considered. In doing so, one must examine the relationship of the worker and the business. Relevant facts generally fall into three categories: (1) behavioral controls, (2) financial controls, and (3) the relationship of the parties.

Behavioral controls are evidenced by facts which illustrate whether the service recipient has a right to direct or control how the worker performs the specific tasks for which he or she is hired. Facts which illustrate whether there is a right to control how a worker performs a task include the provision of training or instruction.

Financial controls are evidenced by facts which illustrate whether the service recipient has a right to direct or control the financial aspects of the worker's activities. These include significant investment, unreimbursed expenses, making services available to the relevant market, the method of payment, and the opportunity for profit or loss.

The relationship of the parties is generally evidenced by examining the parties' agreements and actions with respect to each other, paying close attention to those facts which show not only how they perceive their own relationship but also how they represent their relationship to others. Facts which illustrate how the parties perceive their relationship include the intent of the parties, as expressed in written contracts; the provision of, or lack of employee benefits; the right of the parties to terminate the relationship; the permanency of the relationship; and whether the services performed are part of the service recipient's regular business activities.

As is the case in almost all worker classification cases, some facts point to an employment relationship while other facts indicate independent contractor status. The determination of the worker's status, therefore, rests on the weight given to the factors under the common law, keeping in mind that no one factor is determinative of a worker's status. The letter from General Counsel argues that the district does not have a sufficient level of control over the material details of the members work. However, as further discussed in the next section, the fact that the members may not be common law employees of does not mean that the workers are not common law employees at all.

You have provided a preliminary analysis applying the common law rules to determine whether the members are employees or independent contractors. In that analysis you point out facts such as the State requiring training for all new members and that the members receive instructions and must conduct hearings set forth in a procedural manual. Also, the members make no investment in facilities or equipment and use the copiers, scanners, and recording equipment of The

hires all clerical workers and provides all supplies, materials, and equipment. The members do not incur any expenses, other than mileage expense, in performing their duties. does not reimburse members for this expense. The members provide services personally and may not be members on other review boards. Although the members receive no benefits from cafeteria plans, retirement plans, sick pay, etc., they are covered under the errors and omissions insurance policy. We think you have provided sufficient facts to support a determination that the members perform services as common law employees..

To summarize the law described above, If the members are covered under the Medicare-only section 218 agreement, they are employees for social security tax and Medicare tax purposes under section 3121(d)(4) of the Internal Revenue Code. If the workers are not covered under the section 218 agreement, the Service determines the status of the worker under the common law rules as provided in section 3121(d)(2). Then, whether or not social security tax is owed depends on whether or not the workers are covered by the state retirement system.

appears to object to the use of the common law rules in determining whether the workers were employees by citing Code section , which states:

A person is ineligible to serve on the review board if the person is a member of the board of directors, *an officer, or employee of the district*, an employee of the , or a member of the governing body, officer, or employee of a .

Taxpayer essentially argues that the statute prohibits the members from being employees of , although a disagreement exists between the and regarding the accuracy of that interpretation. The problem with the taxpayer's argument is that treatment of a worker under state law as an independent contractor does not necessarily mean that the worker is also an independent contractor for federal employment tax purposes. See *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990).

State statutes and cases are only relevant to the extent that they illuminate whether a right of control exists on the part of the State or the circumstances of the working relationship for purposes of applying the common law rules. A claim for federal tax exemption must rest upon language in regard to which there can be no doubt as to its meaning and exemption must be granted in terms too plain to be mistaken. *E.g. Matthews v. Commissioner*, 907 F.2d 1173, 1178 (D.C. Cir. 1990). Therefore, a state statutory provision or other document labeling a worker as not an employee would not be controlling for purposes of determining liability for FICA taxes.

3. Who is the Employer?

Section 3401(d)(1) provides, that for purposes of income tax withholding, the term employer means the person for whom an individual performs or performed any service,

of whatever nature, as the employee of such person, except that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” (except for purposes of the definition of wages) means the person having control of the payment of such wages.

Neither the FICA nor the FUTA contains a definition of employer similar to the definition contained in section 3401(d)(1), relating to income tax withholding. However, *Otte v. U.S.*, 419 U.S. 43 (1974), holds that a person who is an employer under section 3401(d)(1), relating to income tax withholding, is also an employer for purposes of FICA withholding under section 3102. *Otte* involved a trustee in bankruptcy who was an employer under section 3401(d)(1) by virtue of having control over the payment of wages owed by the bankrupt. The Court stated, “The fact that the FICA withholding provisions of the Code do not define “employer” is of no significance, for that term is not to be given a narrower construction for FICA withholding than for income tax withholding.” *Otte*, 419 U.S. at 51. The *Otte* decision has been extended to provide that the person having control of the payment of wages is also an employer for purposes of section 3111, which imposes the FICA tax on employers, and for purposes of section 3301, which imposes the FUTA tax on employers. It has been further extended to apply equally to the employer's FICA tax and to FUTA tax¹⁰. *In re Armadillo Corp.*, 410 F. Supp. 407 (D. Col. 1976), *aff'd*, 561 F.2d 1382 (10th Cir. 1977), *In re Laub Baking Co.*, 642 F.2d 196 (6th Cir. 1981), and *STA of Baltimore -ILA Container Royalty Fund v. U.S.*, 621 F. Supp. 1567 (D.C. Md. 1985), *aff'd*, 804 F.2d 296 (4th Cir. 1986) reached similar conclusions.

The preliminary common law factor analysis you provided with regards to whether the members are common law employees also seems to indicate that is the common law employer and therefore liable for employment taxes under the statutory regime. However, we recognize that there may be arguments that another party, such as or the , is the common law employer. The arguments raised by 's general counsel regarding the level of independence from other district business as required by the state statutory scheme are consistent with this general caveat.

If is not the common law employer of the members, it appears that would be the section 3401(d)(1) employer (“statutory employer”), within the meaning of *Otte* and its progeny, because has control over the payment of wages to the members. As stated in your request for opinion, payments to the members were budgeted for in the general budget, paid to each member individually from the checking account, and tracked within the financial statements. There is no indication that is reimbursed by any other party for the compensation paid to the members.

¹⁰ For FUTA purposes, section 3306(c)(7) excluded (and continues to exclude) from employment services performed in the employ of a state, or any political subdivision thereof.

Therefore, as either the common law employer or the statutory employer, is responsible for collecting income taxes from the employee by deducting and withholding the amounts from the wages paid to the members, as well as the employee's and employer's FICA taxes under sections 3101 and 3111.

4. Section 530 Relief

A. General Explanation

Section 530(a)(1) of the 1978 Act, as amended by the Tax Equity and Fiscal Responsibility Act of 1982, provides, in part, that if, for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, then for purposes of applying such taxes for such period with respect to the taxpayer the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating the individual as an employee. For any period after December 31, 1978, this relief applies only if both of the following consistency rules are satisfied: (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee ("reporting consistency rule"), and (2) the taxpayer (and any predecessor) has not treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for periods beginning after December 31, 1977 ("substantive consistency rule"). Section 530(c)(1) of the 1978 Act defines the term "employment tax" as any tax imposed by Subtitle C of the Internal Revenue Code, including FICA, FUTA, and income tax withholding requirements.

When section 530 was enacted, state and local employers were not subject to taxation under either the FICA or the FUTA. Section 3121(b)(7) of the Internal Revenue Code excluded services for such entities from FICA taxes. For FUTA purposes, section 3306(c)(7) excluded (and continues to exclude) from employment services performed in the employ of a state, or any political subdivision thereof.

Although services for state and local governments were excluded from the definition of "employment" in the FICA by section 3121(b)(7) of the Code, social security coverage for such services could be obtained through a section 218 agreement. Social security contributions made with respect to the agreements were not FICA taxes. The regulations relating to the payments and reports of such social security contributions were under the jurisdiction of the Social Security Administration (SSA). At the time of passage of section 530, 42 U.S.C. section 418(e)(1)(A) provided that section 218 agreements shall provide:

[T]hat the State will pay to the Secretary of the Treasury, at such time or times as the Secretary of Health, Education, and Welfare may by regulations prescribe, amounts equivalent to the sum of the taxes which would be imposed by sections 1400 and 1410 of the Internal Revenue Code of 1939 [the predecessors of sections 3101 and 3111 of the 1986 Code], if the services of employees covered

by the agreement constituted employment as defined in section 1426 of the Internal Revenue Code of 1939 [section 3121].

Thus, when states signed on to social security coverage, they contractually agreed to pay the equivalent of FICA taxes (“social security contributions”) with respect to employees within coverage groups.

As a result of this contract relationship with the state, the state had primary liability for social security contributions rather than the employing entity. If SSA established an underpayment of social security contributions under a section 218 agreement, the state was the party liable under the contract, not the governmental entity employing the individual. The Administrator of SSA was empowered to exercise discretion to deduct unpaid contributions and interest from any payment due to the state under the Social Security Act. See section 218(j) of the Social Security Act prior to repeal in 1986. In 1978, only the state, and not the employing governmental entities or the individual workers, had standing to bring suit against SSA for overpayment of section 218 contributions. See section 218(a) prior to its 1986 amendment. This scheme of social security contributions under a section 218 agreement was completely at odds with the focus of section 530 on an individual employing entity's entitlement to relief based on a reasonable basis.

The Omnibus Budget Reconciliation Act of 1986, Public Law 99-509, amended the Social Security Act and the Code to provide that payments for coverage under section 218 agreements were FICA taxes. Section 3121(b)(7)(E) was added to the Code to provide that “employment” includes service included under an agreement entered into pursuant to section 218 of the Social Security Act. In addition the definition of “employee” under section 3121(d) was expanded by adding section 3121(d)(4), which provides that the term “employee” includes any individual who performs services that are included under an agreement entered into pursuant to section 218 of the Social Security Act. The cumulative effect of these amendments is that individuals who are covered under section 218 agreements are automatically treated as employees performing employment for FICA tax purposes, as is discussed above at 2.a.

The premise of section 530 is that, with respect to the employer's liability for federal employment taxes, an individual will not be treated as an employee despite his or her status as an employee¹¹. The classification of state and local employees as employees under section 3121(d)(4) is made specifically with reference to section 218 of the Social Security Act. If the individual is covered under a section 218 agreement, he or she is, by definition, an employee for FICA purposes. The determination of whether an individual is covered under a section 218 agreement is made by the Social Security Administrator and the Social Security Administration under section 210(j) of the Social Security Act. Section 530 relief for FICA taxes is inappropriate, because coverage under the section 218 agreement is dispositive of the individual's FICA tax status.

¹¹ Section 530 has since been modified to provide that application of section 530 is not dependent upon a finding that the individual is otherwise an employee. See Section 530(e)(3).

The legislative history in connection with section 530 implies that section 530 was directed at reclassification controversies between the Internal Revenue Service and taxpayers, and not reclassifications made by Social Security Administrators under section 218 agreements. House Report 95-1748, 95th Cong., 2d Sess. (1978), at page 4, states that:

The bill provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees under interpretations of the common law...The bill provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the Service's proposed reclassification of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees.

Although the legislative history was admittedly written when contributions under section 218 agreements were not treated as FICA taxes, it nevertheless demonstrates the scope of Congressional concern.

The reclassification of workers who are covered under section 218 agreements as employees under section 3121(d)(4) of the Code should be contrasted with the reclassification of other state and local governmental workers. If the worker is not covered under a section 218 agreement, the determination of his or her status as an employee under the FICA will generally be made pursuant to section 3121(d)(2), which provides that the term "employee" includes an individual who is an employee under the usual common law rules. If the worker is an employee not covered under a section 218 agreement, the services of the worker are then examined to determine whether the worker is a common law employee, as well as whether the services are "employment" for purposes of social security taxes and Medicare taxes, under sections 3121(b) and 3121(u).¹² Because the question of whether workers who are not covered under section 218 agreements are employees for purposes of the FICA is made under section 3121(d)(2) and is within the jurisdiction of the Service, the employee-independent contractor determination is ultimately made in the same manner as with private employers. Therefore, with respect to employees not covered under section 218 agreements, the argument about conflict with the section 218 agreement is inapplicable and section 530 relief for FICA taxes and income tax withholding can apply if the usual requirements of section 530 are satisfied.

In the present situation pertaining to the reclassification of workers possibly covered under a Medicare-only 218 agreement, while a determination of coverage

¹² Section 3121(b)(7) excepts from "employment" service in the employ of a state employer or political subdivision employer for FICA tax purposes. However, § 3121(b)(7)(F) expands the definition of employment for FICA tax purposes to include service by an employee who is not a member of a retirement system. Section 3121(u)(2) generally extends the Medicare portion of FICA tax to wages for service performed by employees of states, political subdivisions, and wholly owned instrumentalities thereof hired after March 31, 1986.

under the section 218 agreement means that the worker is an employee for FICA (both Medicare and social security) tax purposes, the Medicare-only 218 agreement establishes contractual liability for Medicare tax only. Accordingly, retroactive Medicare tax liability would be the only part of the FICA that would be barred from potential 530 relief with respect to the covered workers. The employer could still qualify for retroactive section 530 relief from the social security tax.

Another issue is whether an employer can obtain section 530 relief for income tax withholding liability if relief from Medicare tax is unavailable because the employee is covered under a section 218 agreement. There is no provision in Chapter 24, Collection of Income Tax at Source, similar to section 3121(d)(4), providing that a worker covered under a section 218 agreement is an employee. Because the Administrator's determination that an individual is covered under a section 218 agreement would generally be based on the common law rules, a similar result should be reached with respect to liability for income tax withholding after coordination with the Administrator. The Service, however, has jurisdiction over the determination of whether state and local workers are employees for federal income tax withholding purposes. As noted above, the facts in this case support the view that members are officers subject to income tax withholding under section 3401(c).

The income tax withholding provisions have always been exclusively under the jurisdiction of the Service regardless of whether the workers are state and local employees under section 218 agreements. State and local governmental employees were, of course, subject to income tax withholding at the time of passage of section 530 and no exception was provided for application of section 530 to the income tax withholding liability arising from the services of such workers.

Accordingly, if the requirements of section 530 are met, state and local employers may obtain retroactive section 530 relief with respect to social security tax and income tax withholding liability if the reclassified worker is covered under a Medicare-only section 218 agreement.

As a general rule, relief under section 530 continues as long as the employer satisfies the reporting consistency rule (by issuing Forms 1099 when required), the substantive consistency rule, and the reasonable basis test. Under the substantive consistency rule, the employer must treat any workers in substantially similar positions as not being employees to obtain section 530 relief. The withholding of FICA taxes is treatment of a worker as an employee under section 3.03 of Rev. Proc. 85-18. In the case of state and local government entities that are granted relief from income tax withholding liability but not FICA taxes, the question is raised whether relief from income tax withholding liability will apply prospectively, because the entities will be withholding and paying FICA taxes. The substantive consistency rule would seem to prevent the entity from obtaining continuing section 530 relief and require the withholding of income tax prospectively.

A solution to the problem described in the previous paragraph is found in Rev. Proc. 85-18. In particular, the rules provided in section 3.03(C) and 3.04 of Rev. Proc. 85-18 could apply in the case of state and local governmental entities granted section 530

relief only for income tax withholding. Under Rev. Proc. 85-18, the filing of a delinquent or amended employment tax return for a particular tax period with respect to an individual as a result of Service compliance procedures is not “treatment” of the individual as an employee for that period. The procedure provides as an example that, if the Service determines as a result of an audit that a taxpayer's workers are common law employees, that determination is not “treatment” of the workers as employees for the period under audit. However, if the taxpayer withholds employment taxes or files employment tax returns with respect to those workers for the periods following the period under audit, the action is “treatment” of the workers as employees for those later periods.

Section 3.04 of Rev. Proc. 85-18 also provides that a change in the treatment of the worker to “treatment as an employee” creates prospective liability only for the period after the audit. This section gives the example of a taxpayer who did not treat a worker as an employee in 1978 and 1979, but who in 1980 began treating individuals holding similar positions as employees. The procedure states that the employer could still receive relief under section 530(a)(1) for 1978 and 1979. Thus, applying these provisions of Rev. Proc. 85-18 to the case of workers covered under Medicare-only section 218 agreements, relief under section 530 can apply to retroactive liability for social security tax and income tax withholding, but prospectively the employer would be liable for social security tax (subject to application of section 3121(b)(7)) and income tax withholding when the employer began withholding Medicare taxes.

B. Application

If it is determined that the services of the workers are covered under a Medicare-only 218 agreement, then section 530 relief from retroactive social security tax liability and federal income tax withholding is available to the state or local governmental entity if the requirements of section 530 are satisfied. However, prospectively, after the date on which the entity is advised that the workers are covered under the section 218 agreement, section 530 relief for social security tax liability and federal income tax withholding would not be available to the state or local governmental due to the substantive consistency rule. Whether they qualify for section 530 relief depends upon an analysis of the facts.

If it is determined that the services of the workers are not covered under the section 218 agreement, then relief under section 530 with respect to both income tax withholding and FICA tax for the workers is available to the state or local governmental entity if the requirements of section 530 are satisfied.

The facts indicate that appears to meet both reporting and substantive consistency requirements, because it has issued Forms 1099 to the workers and there are no allegations that members were treated inconsistently from one another. However, further factual development is needed to determine if had any reasonable basis for treating the workers as independent contractors, and thus whether satisfies all three requirements to qualify for section 530 relief.

Case development and Litigation Hazards



If you have questions or concerns, please contact the undersigned at (972) 308-7900.

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